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TAXATION, CAPITAL FORMATION, AND PROGRESS

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College students like you will probably pay in direct and indirect taxes more than 40 percent of what you earn in life – some much more. And taxes will affect your life in many ways other than extracting dollars.

The "typical" fully employed American begins to work for himself about May first–or on a daily basis after about 2½ hours. Before that he is working for "the collective" – Federal, state, and local governments. And the family that saves for financial security would find, if it could see the full reality, that governments take no small fraction of what the property produces–often much over half.

Taxes and government spending have been outstanding growth "industries" of modern times. Government spending *per capita* in dollars of today's purchasing power was around $1,130 (Federal, state, and local) in 1955. In slightly more than the twenty years of your lifetime the *real increase* has averaged $244 per year to a total of $9,409 for a family of four.

Are we getting our money's worth? How much better, really, is the "collective" sphere of life–which we use to get most schooling, streets, defense, policing, welfare, retirement pensions, governmental health services, and now hundreds of "subprograms" – how much better than a quarter of a century or a decade ago? In some cases there has been improvement. But would private deployments of, say, half of the increase of tax have produced more of what people want?

Rising Levels of Living

We come into the world with rather little ability. Through the years we do a great deal. We progress from helpless children to adults who are often capable of amazing achievements. These accomplishments, sometimes reflecting progress from generation to generation, depend upon the conditions we create and the framework within which men and women are free to use their capacities.

Looking over the sweep of history, one sees improvements beyond measure. Try to imagine how farmers and town dwellers–or even the temporal and religious rulers, kings and high priests–lived in times we think of as peaks of attainment–Periclean Athens, Rome at its best, the Renaissance in Italy, or Elizabethan England.

Are we smarter than Plato or Newton, more gifted than Rembrandt or Michelangelo, more humane than St. Francis and his disciples, more inventive than da Vinci or Edison, more scientific than Copernicus or Pasteur, keener observers than the astronomers of Egypt or the Mayas, better writers than Shakespeare or King David? Personal qualities of imagination, courage, sensitivity, business acumen, toughness, diplomacy, and so on make for better as against poorer life. All of recorded history offers examples of outstanding human capacity. What conditions favor its flowering? One is the availability of non-human assistance-capital. Another is the hope of reward, of which money is not the least important, *after* tax.

Capital: Introductory Comments

The term "capital" has more than one meaning. I shall generally use it to apply to physical productive facilities–plants, machinery, public utility systems, housing, inventory and other goods in process, transport equipment, and so on. Another usage should be noted: funds used in financing the acquisition of capital goods and the conduct of business

im•pri•mis (im-pri´ mis) adv. In the first place. Middle English, from Latin in primis, among the first (things). . .

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activity. Application of the term "capital" to the productive capacity of human beings is now widely recognized but is not dealt with here.

Some government as well as private expenditure may properly be classed as "investment in human capital." Advocates of higher taxes may argue that they could go for governmental programs which in fact would successfully improve human capital. Such might happen. But there is no assurance of such results. Labeling something as "social" or "human" does not make it worth the cost. Furthermore, the taxes might reduce private investment, human and material, of equal and greater value than the actually realized benefits of the governmental programs.

Income produced but not consumed–savings–provides the funds to pay for adding to the economy's productive capacity. Saving out of family and business income must depend upon the amount of income, *after tax*. Taxes reduce the ability to save.

A dollar saved and used to finance the creation of capital facilities thereby adds to the flow of income through the years. In contrast, a dollar used for consumption, whether by an individual or collectively by government, buys satisfactions for today. But unlike new capital equipment, today's consumption does not support an enlarged flow of *continuing* production.

Some capital, such as housing and hospitals, produces directly for the consumer. Other types–steel plants, chemical factories, machine tools – help in the creation of both consumer goods and more capital facilities. The net productivity of new capital facilities varies widely. Throughout much of the business world, annual pre-tax productivities of 20 to 30 percent appear to be common. Social "payoffs" of this magnitude are very worth having.

Benefits from Capital Widely Diffused

The beneficiaries of capital facilities number far more than the savers who receive interest or dividend income. As consumers all of us depend on the economy's capital base. Whether one looks at changes in living standards over centuries or decades, one must be struck by improvements beyond count and measure. These consumer advances rest heavily upon increases in capital.

The rising power to produce appears not only as consumer goods but also as money incomes. And who gets most of the dollar increases? Human beings as workers–labor–rather than as suppliers of capital. Two thirds to three fourths of additions to income go to people for their time and effort on the job.

As industrial facilities are improved and enlarged, the suppliers of capital get a modest fraction of the fruits. After adjusting for changes in the purchasing power of the dollar, how do wage rates per hour plus fringes compare with those of the past? From 1947 to 1974 private nonagricultural wage rates rose nearly 70 percent. Fringes, I expect, increased by enough to get the total close to a doubling. Over longer periods the real income of workers has multiplied.

What about the returns to capital? Let us think in terms of real return per dollar at work a year. Adjusting for inflation, (a) neither interest nor (b) dividends plus reinvested earnings has risen appreciably. Training and other forms of investment in human capital, of course, account for some of the rise in real return. Although hours at work are remunerated better than in the past, dollars invested do not generally get higher returns.

Capital formation in industry raises the annual flow of real income. Once capital facilities have been added, they can produce year after year if preserved through use of depreciation funds. The capital added in one year will not be large relative to the existing stock. But each unit of new capital would make later additions easier.

The Legacy We Inherit

The typical American takes for granted the extensive accumulation of capital facilities. They have resulted from saving and investment over a long past. Education, health, and other qualities of human beings obviously have great influence on any economy's ability to produce. But capital goods

account for much of the difference between our levels of living and those of our grandparents, and those of other parts of the world. Machines built in the past are used, worn down, repaired, modernized, and replaced. A considerable part–around 9 percent–of the economy's (gross) effort consists of the use of labor, materials, and other inputs to *preserve* the productive capacity inherited from the past. Because of inflation, however, most businesses have been underestimating the true magnitudes of real depreciation.

Growth of Productive Facilities

Each year's growth of capital consists of production which exceeds consumption–machines, electric generators, planes, houses, highways, and so on. Today's consumption, personal plus governmental, draws upon the fruits of past saving as the

capital facilities built earlier produce now. This consumption, however, can use so much of current output that capital grows slowly. Some families and individuals, notably the young and old, may on the average consume almost all of after-tax income—or even more in some cases. Because after-tax earnings are low, corporations may assign little income to be put back into expansion.

The tax money to pay for collective consumption cannot be counted upon to reduce personal consumption in equal amounts. Some of the tax dollars will reduce saving. Some parts of the tax system do more than others, per dollar of revenue, to curtail personal and business saving. Our knowledge of the effects of different taxes on saving is incomplete, but big government financed by graduated income and death taxes will, I believe, reduce the proportion of national income which will be saved.

Government spending may, of course, exceed taxes—deficits. To this extent it is Treasury borrowing that will affect private capital formation. As the Treasury sells new bonds, the funds which it gets are not available to finance private housing or business expansion. The resources used by government are not available for capital formation in the private sector.

Human Costs of Taxes

Taxes have unwelcome aspects too often overlooked by advocates of government spending. By ignoring the effects of taxes required for spending programs, people who feel assured of their own good intentions may promote human distress which they would deplore if facing it directly. Big government can put taxes high enough to create big trouble.

Some dollars come from persons who really suffer from the taxes needed to pay for the extra (marginal) tenth or fifth of spending. To imply that the tax system ought not to burden the poor may salve a conscience. But governments long ago passed the point at which new benefits for the many could be paid for by additional taxes on the few. We continue to have taxes on business earnings, property, sales, and payrolls – taxes which reach the poor as well as the prosperous.

Burdens on millions who think of themselves as middle and upper-middle class force them to do without private goods and services which they would very much like for themselves and their children. We must give up more than merely luxuries. Though working hard and trying to be thrifty, we are unable to command the full fruits of our efforts—and by a considerable amount.

The frequent justification of a spending program as desirable on social grounds should be paired with criticism for the *antisocial* results of the taxes required. Taxes prevent private actions for purposes people want. How can the contrasting results be compared? Under what conditions is the political process more likely to yield a good decision than what people would do freely?

Can we not devise ways to force advocates of greater spending to face, as well as possible, the *human* costs of taxes? Can you think of any cases in which proponents of larger spending have shown serious concern for the human burden of taxes?

Employer's Ability to Hire

Production is what enables employers to meet payrolls. Consumers will pay for output. The worker is fortunate to have productive capital to help him produce salable output.

Jobs can pay well, as a rule, only when much capital equipment supports the worker. Capital per worker tends to be high where earnings are good—in factories, theaters, mines, farms and oil refineries; where retail establishments are well stocked with inventory; where the cranes of construction projects and the trucks and huge trailers of transportation extend the reach of man; when modern computers enable staffs of banks, airlines, insurance companies, and hotels to provide better services. A doctor with his equipment and his "share" of a hospital, or a law office and its library in a building which costs thousands per room to build, are more capital-intensive than we may realize.

Capital as an Issue of Current Tax Policy

Capital "needs" have come into the forefront of debates on Federal tax policy – properly so, because capital is a human tool of pervasive influence. In some senses it resembles liberty as an element enabling men and women to utilize their capacities and in effect to enhance them.

Federal taxation involves many huge and complex issues. Some are specific. Some are imprecise but, as in the case of equity, vitally important. Each year's tax agenda includes dozens of items, each important to some people. Any tax feature of significance will involve conflicts of interest. Tax issues present no goals so clearly defined as "putting men on the moon and bringing them back alive." But we can be more or less deliberate in trying to set (a) the level of taxation (and government spending) and (b) the structure of taxes in light of other objectives beyond revenue.

Need for Capital

To satisfy what seem to me to be generally prevailing anticipations—the living standards we more or less take for granted—the new capital called for will exceed by more than trivial amounts the net new anticipated savings. As a result, expectations will be disappointed.

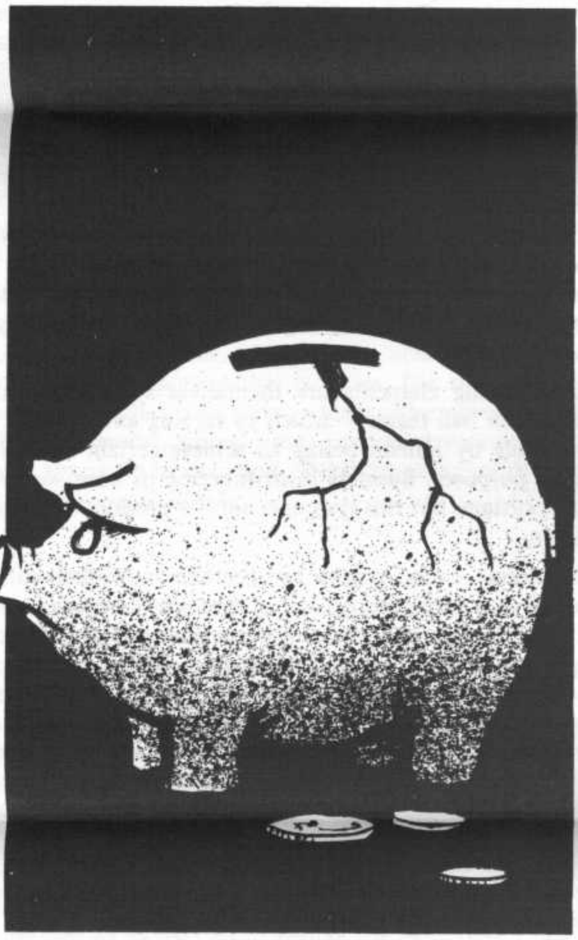
Several studies have looked ahead to estimate capital needs and availabilities. All, of course, must use many assumptions. The conclusions have much in common, but they differ somewhat for the next few years. Debates on tax policy show well reputed economists holding different positions on the capital outlook. To me, certain general points will provide useful guidance.

Many Americans want and expect more from year to year. Our view of the better life throughout the income and age distribution is not a vision of no change but one which at least pictures (1) those low in consumption rising toward the levels of the middle class and (2) the masses who now are the middle class getting more. There are millions more of us than a decade ago, and the population will continue to rise. Scientific advances will make possible new and better things. But providing them will require additions to the capital stock and kinds of productive equipment which do not now exist.

"Need" for capital is an elastic concept. Wishes and desires and goals can be real even when not clearly defined. But all are human creations—and they are subject to change. Difficulties of measurement are formidable. Does a person "need"

$9,000 income a year, or a bit more or less? The response will rest upon many things. Having decided on a figure, say $9,200, can we then specify that he "needs" $20,000 of capital, or more or less, to work with to earn such an income? The answer to that question depends upon many things, including his own skills and technological factors.

In my vision of the good society, everyone should be free to choose among a widening body of alternatives, including those for higher or lower rates of change (progress)–and also the simpler life. But he or she must willingly meet the requirements and accept the consequences, individually and as a member of any group which makes decisions–such as a labor union, college faculty, or a local community. The claims to be pressed in consumption should be consistent with the actions taken to prepare for the future. If we do not save enough to provide the capital, frustrations must result.



Markets provide a mechanism for adjusting wants of various intensities to the ability and willingness to carry the costs. Day in and day out we act and respond, not only balancing output and consumption today but also in accumulating capital. Individuals and families save for the years ahead. Businesses buy and install new capital goods in anticipation of production possibilities and consumer demands over the longer run.

Capital for Good Jobs and Rising Productivity

Providing capital for the future differs from providing shoes or bread for the weeks ahead. The market system cannot reflect now all of the desires which will exist in five or ten years. People quite young, and some unborn, will want goods and services–and good jobs–which cannot be supplied without capital investment in advance, often with long lead times. Parents, of course, try to make some provision for their children by accumulating capital. But by the time children are, say, age twenty, how many parents can supply capital for much more than education? Business firms retain earnings to finance progress. Yet with typical jobs requiring $25,000 to $30,000 of capital each–often much more, when account is taken of the full back-up of production capacity–the dollar amounts are enormous.

The growth of the working force will require capital in the tens of billions each year if earnings are to approximate expectations. The additions to the capital base must come in *advance* of employment. Although a worker may save later out of his earnings, the production facilities must be in place when he starts.

Few young people can themselves supply the capital which they expect to have available for their jobs. Someone else must provide the funds. Election campaign promises will not do so. Not only young persons seeking good jobs, but also those who wish higher incomes, which generally depend on improved productivity, might well consider as their best of friends the people who provide the capital for industry–capitalists.

Rising productivity–usually thought of as output per manhour–accounts for much of the advance in levels of living per capita. To significant extent progress in productivity grows out of more and better capital equipment per worker. Magnitudes may be of interest. Assume a labor force of 95 million (about the 1977 level) which expects $400 a year of higher real income (around 4 percent). Assume that $2 of capital ordinarily will be associated with each dollar of earnings. Then over $75 billion of new capital a year will be required for this purpose alone; all personal saving in 1975, a relatively high level, was around $90 billion.

Environment and Energy: New Capital Needs

The process of capital accumulation by free markets has worked and is working. We do not have all we should like, but improvement comes from year to year. Why, then, any special concern? A compelling reason for unusual concern today is that capital investment must reflect calls for *increases* much above what would have been considered normal not so long ago. Additional incremental needs will be superimposed on an economy already straining to supply housing and industrial demands.

(1) Environmental requirements have been added. Many companies will find new health and safety regulations having the same result. The commands have been issued without anything approximating either a collective –public– decision or a set of personal choices which will balance the expected benefits against capital costs leading to a conclusion, "We shall willingly bear the added expense." Obligations have been imposed–advocates often implying that burdens must fall on "the other fellow"–to achieve good things. To do so, lots of capital will be needed.

"The people," presumably, have decided through political processes (government) that corporations must use large amounts of capital for environmental purposes. But no matching actions have been taken (a) to step up business profit or personal savings or (b) to make more funds available to business by taking from other uses such as housing or government spending.

(2) The change in the energy outlook requires capital in large amounts, not to raise the standard of living but *to prevent a decline.* Billions a year in capital needs have been added without any corresponding increase in the ability and willingness of Americans to save. Nor is there hope for compensating benefits in the form of observable improvements in living standards.

Yields as Indicators of Capital Needs

Another approach to estimating capital is to look at what capital facilities yield in pre-tax profit. In the corporate sector what are the returns which market processes now provide on new plants and equipment? Modern facilities often yield 20 to 30 percent before tax – much above what savers can obtain from bonds. Here, then, is evidence of need for more equity capital than is available.

The tax which corporations must pay on earnings plus the tax on the dividends drives a big wedge between the worth of what capital produces and what the suppliers of the capital receive. The gap deprives the economy of fruits of productive investment which would amply justify their cost. Saving is discouraged. And new funds are misallocated. Capital needs in the sense of production opportunities well worth their costs will be unmet.

Assume that in some sense the normal, real long-run rate of interest with some allowance for risk is around 6 percent a year and that the corresponding yield of equity capital, allowing for more risk, would be perhaps 8 percent, i.e., a debt instrument is more attractive than stock producing less than 8 percent in dividends and capital gains (reinvested earnings). The productivity of capital would provide demand for all the funds (and real resources) supplied at these rates. Federal and state governments impose taxes on the earnings of corporate equity capital–frequently 50 percent or more. Thus only projects producing at least 16 percent can offer the equity investor 8 percent. As a result, corporate investment undertakings which require equity finance and which do produce yields of 15 or 14 percent or less will not be attractive. A whole range of investments for which there is need as evidenced by productivity–pre-tax yields over 8 but less than 16 percent–will not be attractive to equity finance.

Revision of Tax Structure: Leadership Role

Would it be possible to have free-market and tax-neutral arrangements for capital accumulation and preservation? Can democratic processes really express "true" preferences of men and women in the future? Is some special role for leadership called for?

The corporation income tax, firmly established, involves rates which inevitably complicate matters enormously. No neutral or really voluntary, free-market system for attracting and rewarding capital can be expected.

Some difficulties arise out of the fact that we try to tax people on the basis of both income and capital. Inevitably, the two are related and in ways that confuse taxation, e.g., depreciation and changes in prices of capital items. And when inflation exists, taxation to recognize unknown future costs becomes obviously difficult.

When a philosophy of egalitarianism gains influence, use of the tax instrument to draw relatively heavily upon owners of capital seems natural. The demagogue, or even some who believe they are serving a good purpose, support tax policies which discriminate against accumulated wealth and the incomes from which new savings can be made. We now have such elements.

Let us look at another aspect. The wishes of workers and consumers of the future cannot be reflected in markets today. My wishes for fish, belts, and gasoline today are shown by what I do. Who of us, however, reveals now what he will want in 5 or 15 years? How can we ourselves act now, or be sure that others will do so, to make available the capital required?

Business as Our Agencies for Producing

For (1) the production of most goods and services, and for (2) the creation of most of our income, we act together in businesses, millions of them. They organize resource use by selling and buying in markets. These markets give people cpportunity to form and to express their wishes, individually and in groups, day in and day out.

The operations of a market economy are intricate and inter-related–and not generally understood. The widely varied parts serve one another without any conscious determination. No central directing system operates. Nor is there any single set of purposes. Each person, and each business, has a set of purposes. Though millions of the different units depend to varying degrees on each other, they are separate entities.

Functioning elements are themselves systems – airlines, factories, or ball teams – which to varying extent result from plans made by human beings to achieve certain more or less specific purposes. Business firms function in what we call the market system, but this system is not the product of deliberate creation.

Economic order results because the individual units are themselves independently acting agencies, conscious humans and groups of people with their own purposes who adjust and adapt. Myriads of small, individual, changes reflect what people want and can do. Rivalry and competition put pressure on participants to do what others want. Rewards relate to the worth which others attach to what is produced by a company.

Business Taxes

Taxes on corporate earnings at marginal Federal plus state rates over 50 percent offend against the principle of less rather than more hindrance to efficiency in production.

Why has this country resorted to such high tax rates on businesses? Politics. And politics in an environment in which competitive pressures do not put the inferior "product" – argumentation – at a disadvantage will neither drive it out nor force improvement.

How could one find a constructive reason for hitting companies which provide good jobs in the hundreds of thousands? Or the business which supplies products in vast variety that consumers in the tens of millions freely select? If good jobs, if attractive products, are desirable, it seems foolish to tax heavily the businesses which provide them. Is it not self-defeating to concentrate tax burdens on corporations because they put to fruitful use the savings of hundreds of thousands of families?

How would a candidate for elective office fare if he were to advocate moderation of taxes on business? He could say, and say correctly, that he speaks for the true interests of the individual (as earner and as consumer and as saver). But in how many constituencies would this good idea drive out the bad?

Businesses are our chief instruments for production – more than 82 percent of total goods and services. Taxes cannot help, and will inevitably impede, businesses. Excess burdens result. People must bear the burdens. We shall have more output (and income) for all purposes if businesses as such are freer from tax impediments. Then let us tax individuals as recipients of the income they get for their labor and for supplying capital. Then they will have more to enjoy as consumers (including leisure if they choose) and for saving.

The two-tier (double) taxation of dividends is now getting long-overdue attention. The Treasury and others have made proposals for reducing the two-fold tax on dividends and on capital gains which result from the retention of taxed profit. Another approach would use whatever scope for burden reduction seems possible (1) to make really adequate allowances for inflation in computing depreciation and (2) to cut the 48 percent Federal corporate rate.

Special tax provisions to encourage personal saving have appeal. Yet their net effectiveness is less clear than might be imagined. They justify attention. But a more immediate tax goal might well be adjustment for inflation. The owner of a savings account or bond is taxed on the full interest even though much of it may be no more than an offset to the loss of purchasing power of his investment.

Property Taxation

Property taxation has always been a major element in the finance of American government. In many places it is high. Reform offers exceptional promise. In most places much remains to be done along lines that have long been recognized as desirable, notably improvement of administration. A more basic revision offers opportunity greater than I can explain here. The reform which I propose would reduce the effective tax rates on buildings, machinery, and other man-made capital and rely more fully on land values.

The amount we pay for the use of land has little to do with the amount in existence. Unlike machinery and buildings, the quantity of land, with some exceptions, does not depend upon the amount paid. What we pay to purchase or rent land depends upon demand relative to an essentially fixed supply. A government can take in annual tax a small, or a large, portion of the flow of benefits from land without altering the quantity of this resource. In contrast, a high tax on buildings or machinery will keep the supply in the area lower than otherwise.

No big change should be made abruptly. But in a period of five to ten years much could be done to shift property tax from man-made capital to land values with substantial benefits in better land use, more progressive improvement of housing and other forms of capital, and in equitable distribution of the costs of local government.

In Conclusion

The beneficiaries of capital facilities number far more than the savers who receive interest of dividend income. As consumers all of us depend on the economy's capital base. Capital formation in industry raises the flow of real income. To continue as a nation not only in increased productivity and earning capacity, but also simply in maintenance of existing productive capacity, capital must be allowed to accumulate.

I doubt that even a tiny minority of the present labor force or those who claim to speak for them appreciate the role of capital. Political support for saving and building of wealth seems to offer little promise of popular acclaim or votes at elections. Nevertheless, I believe, education can help people free themselves from hidden burdens of misguided tax policy.

Hillsdale College is marked by its strong independence and its emphasis on academic excellence. It holds that the traditional values of Western civilization, especially including the free society of responsible individuals, are worthy of defense. In maintaining these values, the college has remained independent throughout its 131 years, neither soliciting nor accepting government funding for its operations.